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THESIS

**EVALUATING THE RECORD OF THE COALITION
PROVISIONAL AUTHORITY'S MACROECONOMIC
REFORMS IN IRAQ**

by

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December 2011

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AUTHORITY'S MACROECONOMIC REFORMS IN IRAQ**

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Lieutenant, United States Navy
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ABSTRACT

This thesis measured three aspects of the Coalition Provisional Authority's macroeconomic reforms for transitioning Postwar Iraq; the degree of Central Bank independence; the success of the currency exchange; and whether the program of shock therapy weakened macroeconomic reforms. The premise behind implementing liberal economic reforms in Iraq was that creating a market-oriented economy would increase internal stability and would integrate Iraq into the global economy. Moreover, an integrated Iraqi government would be less likely to engage in hostile action against its own population or its neighbors. This thesis scored the actual degree of Central Bank independence at .64 according to the most widely accepted measure established by Cukierman, Webb, and Neyapti. This thesis also proved the CBI effectiveness at targeting inflation, which is another indicator of central bank independence. The CPA's program of dinar consolidation unified Iraq's dual monetary system and helped erase Saddam's legacy of economic incompetence. The goal of shock therapy was to avoid the obstruction and interference that might have accompanied a protracted step-by-step approach. Rather than being rejected by a popular backlash or overturned by the Iraqi government, the CPS's macroeconomic reforms remain vital. Although these reforms did not resolve all the structural hurdles in the economy, this research finds that the CPA's neoliberal economic policies have created the necessary groundwork for the further development of independent macroeconomic institutions.

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LIST OF ACRONYMS AND ABBREVIATIONS

| | |
|------|--|
| CBI | Central Bank of Iraq |
| CEO | Chief Executive Officer |
| CIA | Central Intelligence Agency |
| CPA | Coalition Provisional Authority |
| DLR | De La Rue |
| GDP | Gross Domestic Product |
| IMF | International Monetary Fund |
| NSPD | National Security Presidential Directive |
| UK | United Kingdom |
| UN | United Nations |
| WTO | World Trade Organization |

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I. INTRODUCTION

After the fall of Saddam in 2003, rebuilding Iraq's economy posed a major challenge to post-war reconstruction. Years of war, sanctions, and mismanagement by the Baathist regime had decimated Iraq's economy. The economy required monetary reforms to manage the quantity of money in circulation and to control the interest rate.¹ Authorities on reconstruction believed that delivering measurable economic improvements could increase the legitimacy of the new Iraqi government.² Thus, reforming Iraq's monetary system was among the initial priorities of the Coalition Provisional Authority (CPA) in 2003.³ The CPA issued several bank orders of which Order Number 90 and 93 outlined the framework of an independent Central Bank modeled after modern western standards.⁴ Another element of the CPA's monetary decisions was to introduce a new Iraqi currency. By far the most controversial CPA decision was to use "shock therapy" rather than a gradual process for implementing monetary reforms. Although scholars debated whether the rapid pace of implementation hindered the process of reform,⁵ there was broad agreement that promoting central bank independence and a credible currency were crucial to economic reconstruction.⁶ This thesis examines three specific questions regarding the CPA's macroeconomic reforms: 1) Did the CPA create an independent Iraqi central bank; 2) Did the new Iraqi dinar reduce political and economic instability; and 3) Did "shock therapy" limit the sustainability of monetary reforms?

¹ Robert Looney, "Postwar Iraq's Financial System: Building from Scratch," *Middle East Policy*, (2005), 137. http://www.relooney.info/Rel_MEP_05.pdf 12, no. 1.

² Sharon Otterman, "Iraq: Who's in Charge," *Council of Foreign Relations* (2004): 4. <http://www.cfr.org/iraq/iraq-s-charge/p7798>, 4.

³ Bathsheba Crocker, "Reconstructing Iraq's Economy," *The Washington Quarterly* (2004): 6. http://www.twq.com/04autumn/docs/04autumn_crocker.pdf.

⁴ Looney, "Postwar Iraq's Financial System: Building from Scratch", 137

⁵ Joseph Stiglitz, "Iraq's Next Shock Will be Shock Therapy," *Znet* (2004): 2. <http://www.zcommunications.org/iraqs-next-shock-will-be-shock-therapy-by-joseph-stiglitz>.

⁶ Karsten Staehr, "Reforms and Economic Growth in Transition Economies: Complementary Sequencing and Speed," *The European Journal of Comparative Economics* 2, no. 2. <http://www.freepatentonline.com/article/European-Journal-Comparative-Economics/151318030.html> (2005), 8.

A. IMPORTANCE OF THIS TOPIC

This study has important implications for United States (U.S.) foreign policy with direct application to ongoing operations in Afghanistan and future operations where U.S. military intervention may be required to liberalize authoritarian regimes. Whether Iraq develops a stable market-oriented economy is also of significant importance to the stability of the region. An Iraq that is an integrated part of the global economy is less likely to engage in hostile action towards its neighbors or to be so unstable as to create regional instability. A developing Iraq would also serve to undermine the statist economic systems of other countries, to include Iran. As such, investigating the theoretical and practical assumptions behind the CPA's strategy for transitioning Iraq's monetary system provides insights into the broader thinking about stabilizing post-war countries. Specifically, this study makes an important contribution to understanding the impact of liberal economic reforms in post-conflict environments.

B. PROBLEMS AND HYPOTHESES

The first hypothesis is whether the CPA's monetary reforms in Iraq resulted in meaningful central bank independence. One of the first economic reforms that the CPA introduced in Iraq was to structure an independent central bank.⁷ Authorities believed that creating an independent central bank was necessary to control inflation and stabilize the flow of currency. In theory, an independent central bank would prevent government interference in the economy and allow banking authorities to focus on controlling prices and inflation. The consensus among economists was that "the long-run objective of monetary policy must be price stability, or, to put it more generally, control of the absolute level of prices."⁸ Concerning the tactic for achieving price stability, Friedman claims here too there is consensus on a monetarist policy. I will therefore measure the extent to which Iraq's central bank maintains independence from government manipulation.

⁷ Looney, "Postwar Iraq's Financial System: Building from Scratch", 136.

⁸ Milton Friedman, "Monetary Policy: Theory and Practice," *Journal of Money, Credit and Banking* 14, no. 1 (1982): 100. <http://www.jstor.org/pss/1991496>.

The second hypothesis tests whether the CPA's introduction of a new currency with a floating exchange rate has controlled inflation in Iraq's economy. There was much debate about whether to keep the Saddam Dinar, peg the Dinar to the U.S. dollar or develop a new Dinar altogether. The CPA decided to phase out the old Dinar and print new currency notes. Debates also surrounded valuation of the new dinars by pegging to the U.S. dollar or introducing a currency board. Authorities believed that pegging the Dinar to the U.S. dollar would project overt imperialism and incite questions about Iraq's sovereignty. To evaluate whether the floating exchange rate dinar controlled inflation in Iraq I will review official data from the Iraqi Central Bank, along with reports from the World Bank and IMF.

The third hypothesis investigates whether the CPA's decision to implement "shock therapy" reduced the viability of monetary reforms. The CPA intended to make Iraq one of the most open and unregulated economies in the world. Critics debated whether abrupt liberation of markets and prices would necessarily lead to economic growth.⁹ I will examine Iraq's existing Central Bank laws to determine the extent to which CPA monetary orders have been modified or overruled. The stickiness of CPA reforms in Iraq would diminish the claim that shock therapy reduced reform viability.

C. METHODS AND SOURCES

My analysis is a case study that consists of four parts. Part one outlines the CPA bank orders, and compares them with the generally accepted theory and practice of structuring a modern monetary banking system. The primary source for evaluating currency reform will include the CPA Bank Orders and official reports regarding the creation of a new Dinar. Part two of my analysis will evaluate Iraq's central Bank independence. Sources for evaluating central bank independence will include CPA bank orders and other laws produced by Iraq's interim government. I will measure Iraq's central bank independence by creating an index modeled after the Cukierman, Web, and Neyapati index, the most widely used index for central bank independence. Sources for

⁹ Bassam Yousif, "Economic Policies in Iraq: Motivations and Outcomes," *Third World Quarterly* 27, no. 3 (2006): 501. <http://www.tandfonline.com/doi/abs/10.1080/01436590600587770#preview>.

implementation policy will include official statements and reports produced by CPA officials. Part three of my analysis will measure the stickiness of CPA reforms. I will examine the degree to which the CPA's orders and intermediate laws promulgated in 2003–2004 remain present in current Iraqi law and constitution. Primary sources for that analysis include data from Iraq's central bank, Iraq's constitution, International Monetary Fund, and World Bank reports.

D. THESIS OVERVIEW

Chapter I of this thesis examines Iraq's economy prior to 2003. Chapter II of this thesis reviews the literature concerning the CPA's involvement in Iraq (2003 to 2004) and summarizes the assumptions behind the CPA's rapid reform of Iraq's currency and central bank. Chapter III of the thesis examines the currency transition and banking law that the CPA introduced in Iraq during 2003 and 2004. This chapter answers the following specific thesis questions: 1) How independent of executive branch influence is the Iraqi central bank; 2) Did the new dinar help decrease political or economic instability; and 3) Did the CPA's program of shock therapy degrade the durability of monetary reforms in Iraq? Although the consensus regarding the CPA's overall performance has been negative, critics claimed that macroeconomic reform was the single bright spot of the CPA's legacy in Iraq. The thesis examines specific macroeconomic policy of the CPA to see whether the empirical evidence supports that program of reform. Chapter IV summarizes the thesis findings.

II. IRAQ BEFORE 2003

Saddam Hussein was president of Iraq from 1979 to 2003. His economic priority in Iraq focused on fixing prices to manage consumption. His policies resulted in government command and control over Iraq's oil production and revenues, trade and banking, foreign exchange rates, and domestic subsidies.¹⁰ During the early years mounting revenues from the 1973 Arab oil embargo enabled the government to ignore fiscal discipline to garner political support through large-scale industrial investments and redistribution of oil revenue.¹¹ Saddam's economic program was a continuation of the two consecutive five-year economic plans that had begun prior to his presidency. The goal of the first five-year plan was economic independence through nationalization of the petroleum and other extractive industries. The second five-year economic plan coincided with the emergence of the oil boom, which resulted in increased investment in the petrochemical and raw mineral industries. Unfortunately, economic management and central planning under Saddam was unorganized and the state did minimal actual planning. Infrastructure for the petrochemical complexes in Basra and steel mills in Khor al-Zubair lacked the necessary transportation and supply networks. Additionally, workers seldom held the required technical or managerial qualifications for overseeing industrial operations.¹²

From the early 1970s, approximately fifty percent of government investment was directed toward the extractive industries of oil and mineral. This policy was underwritten by low interest loans from Iraq's national banks. Loans provided by the Industrial Bank grew from 12.5 million Iraqi Dinars in 1967–68 to 12.5 million dinars in 1977. The government also granted the private sector legal exemptions and immunity from

¹⁰ Anthony Cordesman and Ahmed Hashin, *Iraq: Sanctions and Beyond* (Bolder, CO: Westview Press, 1997), 42.

¹¹ Jonathan Sanford, *Iraq's Economy: Past, Present, Future* (Washington DC: Congressional Research Service (2003): 4. <http://www.au.af.mil/au/awc/awcgate/crs/rl31944.pdf>.

¹² Cordesman and Ahmed Hashin, *Iraq: Sanctions and Beyond*, Westview Press (February 7, 1997) 42.

taxation.¹³ These financial distortions created a condition wherein the growth in private industry had no relation to Iraq's productive capacity.¹⁴ The expansion in private sector activity was reflected in two decrees, the Law regulating Industrial Investment in the Private and Mixed Sectors, No. 115 and Company Law, No. 36. Both decrees increased the cap in capital investment allowed for private sector projects and joint stock companies. The laws also permitted Iraq's Industrial Bank to loan companies 120 percent of required capital.¹⁵ Law 157 of 1973, the Law for the Execution of Major Development Projects, absolved "important" engineering and construction industries of taxes and legal restrictions. Unfortunately, the largest projects with the most widespread effect on the rest of the economy, such as petrochemical, iron, steel and phosphate complexes, came under the tax exemptions of law 157. Thus, Saddam's economic policies deprived the country of revenues from the major industries of growth.¹⁶ The first Arab oil embargo coincided with Saddam's first ten years in power. Economic data shows that Iraq's GDP was at 1.2 billion dinars in 1970 and peaked at \$15.8 billion dinars at the end of his first decade as president due to the oil boom.¹⁷ Economic growth slowed in the 1980s, barely reaching 15 billion dinars in 1985. This economic deterioration resulted from mobilizing industrial, financial and other resources to support military spending.¹⁸

A. IRAQ'S BANKS

The first Central Bank Iraqi was established under Law no 72 in 1956 and amended in 1976 under Law 64. Although little information exists concerning the

¹³ Isam al-Khafaji, "The Parasitic Base of the Ba'Thist Regime," in *Saddam's Iraq: Revolution or Reaction*, ed. Committee Against Repression and for Democracy, 78 (London: Zed Books, 1986).

¹⁴ Ibid., 78.

¹⁵ Ibid., 78.

¹⁶ Ibid., 80.

¹⁷ Republic of Iraq Ministry of Planning, "National Development Plan for Years 2010-2014", 42 <http://iq.one.un.org/documents/83/NDP%20English.pdf>.

¹⁸ Ibid., 50.

functioning of these banks, the available record suggests that these banks merely produced statistics on the following monetary and financial data:¹⁹

- Net foreign assets of CBI
- Claims on the Central Government
- Claims on other depositary organizations
- Monetary base (currency outside of banks and bank reserves)

The Agricultural Bank was established in 1936 and traditionally financed private sector agriculturalists. The Industrial Bank was split off from the Agricultural Bank in 1940 to finance both public- and private sector companies. Few commercial banks existed in Iraq before a prominent member of the Chalabi family formed the Rafidain bank as a private bank in 1941. The Real Estate Bank was founded in 1949 to provide housing construction loans and to finance the tourist industry. The Commercial Bank, the Credit Bank, and the Bank of Baghdad rounded out the list of domestic banks. Foreign banks in Baghdad included the Ottoman Bank, the British owned Eastern Bank and the British Bank of the Middle East, the Federal Bank of Lebanon; the National Bank of Pakistan, and the Lebanese owned Intra Bank. In 1964 a wave of mergers and consolidations produced four banking groups: Rafidain; Commercial; Bank of Baghdad; and Credit Bank. Further consolidation in 1970 forced banks to merge into either a Rafidain or a Commercial bank. In 1974, the Commercial group formally converted to Rafidain banks, leaving Iraq with one state-owned bank. In 1989 the Rafidain Bank spun off its non-performing assets into the Rashid bank.²⁰ In 1991 after the Gulf War Saddam permitted businessmen and prominent families to establish private banks but only the Rafidain and Rasheed banks were allowed to finance state owned enterprises.²¹

Looters stole three hundred million Dinars from the Rafidain and burned several bank branches. The Rashid Bank losses totaled approximately sixty-nine million dinars.

¹⁹ David Munro, "Overview of the Iraqi Banking System: The State Owned Banks," *United States Agency for International Development* (2003): 1, http://www.izdihar-iraq.com/resources/bankingconf07/bankconf_pdfs/ref_ses5_munro_overview_iraqi_bankg_soes_032107.pdf.

²⁰ Ibid., 2.

²¹ Ibid., 2.

Many private banks avoided similar losses by hiding money in Iraq's Central Bank vault prior to the war. Thus Iraq's public banks became essentially insolvent due to mismanagement, wartime looting and losses to state owned enterprises, Iraq's private banks benefited from Saddam's ban on public sector lending.²²

B. DINAR INFLATION

During the period from 1950 to 1980, the National Bank of Iraq maintained 100 percent reserves behind the Iraqi dinar and the exchange rate hovered between \$3.00 and \$3.38 per dinar.²³ From 1960 to the period leading up to the oil boom the Iraqi economy held a fairly stable inflation rate ranging between five and six percent. When the Saddam came to power he started a program of rapid industrialization that injected 5.199 billion dinars in the industrial sector. This figure represented a 15 times increase over the spending that had taken place between 1959 and 1969.²⁴ The war with Iran produced the accelerated printing of Iraq's currency and the Gulf War only increased the rate of the dinar's decent. In spite of advantageous tax and bank lending policies, the 14 percent growth in manufacturing between 1968 and 1981 was matched by the rate of inflation, which was 16 percent percent between 1968 and 1975 and approximately 25 percent from 1975 to 1980.²⁵ Thus, there was no real growth in the non-oil sector of Iraq's economy during the first decade of Saddam's rule. Between 1975 and 1979 the oil boom sent inflation fluctuating between eighteen percent and sixty-eight percent. Price instability increased as Iraq diverted resources for war and increased government borrowing from the central bank. Inflation grew from ninety-five percent in 1980 to four hundred percent in 1989. From 1990 to 1991, inflation measured in food prices surpassed two thousand percent.²⁶

²² Ibid., 3.

²³ Jonathan Sanford, *Iraq's Economy: Past, Present, Future*, Congressional Research Service (2003): 4. <http://www.au.af.mil/AU/AWC/awcgate/crs/rl31944.pdf> 4.

²⁴ Cordesman and Hashin, *Iraq: Sanctions and Beyond*, 128.

²⁵ al-Khafaji, *The Parasitic Base of the Ba'thist Regime*, 128.

²⁶ Sanford, *Iraq's Economy: Past, Present, Future*, 4.

C. DEBT

Cash from the 1970's oil boom enabled Iraq to finance economic development directly, decreasing its reliance on foreign creditors. Additional restrictions on foreign direct investments resulted from the Baathist's program of economic nationalism. By 1989 Iraq was in the midst of a severe debt crisis that even the oil boom could not rectify. At the end of the war with Iran in 1988 the country owed \$27 billion to Western creditors and nearly \$50 billion to neighboring Gulf States.²⁷ In 1991, the UN reported that Iraq's debt totaled \$42.1 billion. Iraq's foreign debt grew from several sources. Loans from the Western creditors in the amount of \$35 billion provided military assistance, development finance and export guarantees. Another \$7–8 billion in loans from the Soviet Union and other Eastern European States funded development projects. Several Gulf States, including Saudi Arabia, Kuwait and the United Arab Emirates, extended \$30-\$40 billion in credit for the war with Iran.²⁸ The wars forced Iraq to borrow from foreign creditors to finance the military and continue economic development projects. Eight years of war with Iran buried Iraq's economy under a \$80 million mountain of debt.²⁹ The war with Kuwait and resulting sanctions dashed any hope of any economic recovery. Wars and sanctions and economic mismanagement lowered Iraq's GDP, increased both debt and inflation, prevented foreign investment, and distorted the currency.³⁰

D. DUAL CURRENCIES

The Gulf War sanctions imposed under Section 41 of the United Nations Charter lasted 12 years, and targeted Saddam and Iraq's ruling elite. Unfortunately most of the economic burden fell on ordinary Iraqi citizens. The ruling elites were able to siphon the revenue from the UN's Oil for Food program and other humanitarian aid. Additionally, imports from the oil for food program distorted the incentives for domestic food production. As a result of the sanction's ban on oil exports and the resulting 80–90

²⁷ Cordesman and Hashin, *Iraq: Sanctions and Beyond*, 128.

²⁸ Ibid., 133.

²⁹ Sanford, *Iraq's Economy: Past, Present, Future*, 133–134.

³⁰ Ibid., 114.

percent reduction in budget revenues, Saddam could not afford to purchase dinar notes from the usual foreign printers. Left with only a limited supply of pre-1990 currency on hand, Saddam authorized the Central Bank to establish a currency-printing operation inside Iraq. The resulting “Saddam dinar” carried the image of Saddam and was produced using commercial rather than security printing technology. The relative independence of the Kurdish region meant that the new Saddam dinars were restricted to central and southern Iraq where Saddam maintained control. In the Kurdish region the pre-1990 “Swiss dinar” that was printed in Switzerland held a stronger value than the Saddam dinar. The Kurds neither established a printing operation nor engaged in wartime deficit financing. As a result, the two national currencies in circulation in Iraq held different values: the depreciating Saddam dinar in the middle and southern Iraq versus the stronger Swiss dinar in the North.³¹

E. CONCLUSION

Iraq benefited from a spectacular increase in oil revenue between 1973 and 1983 (60 percent of GDP) as the state controlled the largest source wealth within the economy.³² By the mid 1980s, economic losses resulting from the war with Iran encouraged Saddam to replace profligate state spending with more practical economic reforms that benefited private enterprise.³³ In addition to the state divestment of agriculture, in 1983 the government repealed nationalization policies enacted in 1964 and encouraged large-scale private investments in all industrial sectors of the Iraq’s economy. Other important reforms involved drastic reductions in the taxes paid by private industry from 75 percent to 35 percent. By 1989, all industries received a ten-year tax holiday. Trade policy reflected equally drastic reversals. Before 1988, all imports had been previously managed by the state. After 1988, Saddam liberalized private sector imports and promoted exports by lowering the exchange rate of the Iraqi dinar.³⁴ Despite

³¹ Simon Gray and Jacob Nell, *A New Currency for Iraq* (London: Central Banking Publications, 2005), 24.

³² al-Khafaji, *The Parasitic Base of the Ba'Thist Regime*, 74.

³³ Marion Farouk-Sluglett and Peter Sluglett, *Iraq since 1958* (New York: St Martin Press, 1990), 278.

³⁴ Kamil Mahdi, *Iraq's Economic Predicament* (Redding, UK: Garnet Publishing, 2002), 246.

Saddam's apparent attempt to implement reforms, the state remained heavily involved in managing and controlling the economy. Thus, rather than an actual decline in the influence of the state in the economy, the state merely shifted the types of activities to control. Iraq's economic situation in the late 1980s reflected the shortcomings of the longstanding socialist state bureaucracy that had only begun to enact more market-driven economic reforms in 1987. Further, economic distortions produced by wars with Iran, Kuwait and the United States intensified Iraq's economic crisis, decline in living standards and instability.

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III. LITERATURE REVIEW

From 1991 to 1996, Iraq's per capita GDP remained below \$508. Although the CIA World Fact Book on Iraq reports that GDP figures for the years leading up to the 2003 invasion were unreliable, they report that the pre-invasion growth rate hovered around zero percent.³⁵ Iraq had one of the world's lowest per capita income rates at the time of the invasion. The literature on economic development of transitioned economies has prescribed numerous strategies for growth, ranging from capital investment to foreign aid.³⁶ Research presented by Levine provides empirical evidence that reforms within the banking sector may spur long-term economic growth. His study proved that countries that had enacted banking reforms to ease credit in the private sector achieved higher GDP growth than countries with more restrictive credit policies. Moreover, Levine's study linked variation in cross-country levels of creditor protection with long-run growth rates, including growth in GDP per capita.³⁷ The studies highlight unique institutional and legal conditions that had corresponded with economic growth. Although research has demonstrated that sound monetary policy within the banking sector promotes long-term economic growth, none of the growth models had focused on reforms of the banking sector.

A. BANK REFORMS

Recent studies of banking sector reforms in transitioned economies stress that sound monetary policy for foreign and domestic banks operating in transitioned economies promote economic growth. As the CPA sought to jumpstart Iraq's economy, it correctly focused on regulating the banking sector. In September 2003, the CPA introduced a series of liberal banking laws to liberalize Iraq's economy. Since that time the propriety of those laws and effect of the reform have remained sources of contentious

³⁵ Central Intelligence Agency, "Iraq Economic Data (1989-2003)," *CIA World Factbook* (2011): 3. https://www.cia.gov/library/reports/general-reports-1/iraq_wmd_2004/chap2_annxD.html.

³⁶ William Easterly, *The Elusive Quest for Growth* MIT Press, Cambridge, Mas (2002), 62.

³⁷ Robert King and Ross Levine, "Finance and Growth: Schumpeter might be Right," *Quarterly Journal of Economics* 108, no. 3 (1993): 605. <http://www.jstor.org/pss/2118406>.

debate. By the time the CPA arrived in 2003 Iraq had no ability to affect monetary policy. The central bank could neither regulate interest nor the quantity of money and credit in the economy. No market existed for either government security or private debt and Iraq had no interbank system for handling payments. The absence of these important markets made it virtually impossible for the CBI to set interest rates and provide liquidity.³⁸ CPA order # 40 known as the Banking Law instituted a Central Bank of Iraq (CBI) that was independent of government coercion and control.³⁹

Theoretically, independent central banks prevent inflation and provide liquidity to private banks. Also independent central banks are attractive to foreign investment. Economist Robert Looney claimed that the 2004 Central Bank Law created a modern CBI that was independent of government coercion and control.⁴⁰ Cecchetti expressed confidence in the decision to constitute an independent central bank. According to Cecchetti, consensus that has developed over several decades insists that “central banks must be (1) independent of political pressures; (2) accountable to the public; (3) transparent in its policy actions; and (4) a clear communicator with financial markets and the public.”⁴¹ Of the listed requirements, Cecchetti highlighted independence as the most important.

Other experts argued that central bank independence would be difficult to obtain under the best circumstances. Success would be much less attainable in Iraq given the country’s post-war institutional deficit. “Simply put, no central bank can be independent without a strong dose of fiscal control...Indeed, so long as there is a central bank, Iraqi governments will have less incentive to follow the rules of fiscal prudence. Faced with a soft budget constraint, the fiscal authorities will force the central bank to cooperate in financing its deficits.”⁴²

³⁸ Looney, *Postwar Iraq's Financial System: Building from Scratch*, 138.

³⁹ *Ibid.*, 137.

⁴⁰ *Ibid.*, 137.

⁴¹ Stephen Cecchetti, “How to Establish a Credible Iraqi Central Bank,” *International Economy* (2003): 85. http://international-economy.com/TIE_Su03_Cecchetti.pdf.

⁴² Steve Hanke and Matt Sekerke, “Monetary Options for Postwar Iraq,” *Foreign Policy Briefing* 80, no. 80 (2003): 6. <http://www.jhu.edu/~iaesbe/Iraq.pdf>.

B. SHOCK THERAPY

Although there was agreement in 2003 about the propriety of market-based reforms, debates surfaced about how best to implement those reforms. Proponents of “shock therapy” believed that fragmented reforms were ineffective and argued instead that comprehensive liberalization would both concentrate and minimize hardships. Gradualists argued in favor of reforms applied sequentially within specific sectors and among a defined set of activities.⁴³ The Coalition policies in Iraq followed the first approach.

In Baghdad Year Zero, Naomi Klein takes issue, not only with the radical liberalism/idealism of the CPA bank reform, but also with the “shock therapy” with which they were implemented. Klein had argued that Bremer's economic reforms/investment laws might have shocked Iraq's businessmen into more profitable arrangements such as funding the insurgency.⁴⁴ Bassam Yousif agreed that the CPA banking sector reforms had succeeded in making Iraq one of the most open and unregulated economies in the world. But, he argued, sustained growth would not be achievable because the abrupt liberation in markets and prices had not corresponded with bank lending to the private sector to increase the capacity of production. “Investment difficulties in Iraq have stemmed not from the lack of financial capital but from the low capacity of the economy to absorb investments...this underscores the importance of financial assistance to the success of shock therapy and brings out an interesting irony to this approach.”⁴⁵ Yousif saw parallels in CPA reforms and Iraq's bank nationalization in 1964 that eroded the rights of domestic industrial and commercial businesses. “Hasty and inappropriate Coalition policies have therefore reinforced the extant anxieties about the market and buttressed the traditionally tentative character of property rights.”⁴⁶ Christopher Coyne predicted that the CPA's economic reforms would be unsuccessful

⁴³ Naomi Klein, “Baghdad Year Zero: Pillaging Iraq in Pursuit of a Neocon Utopia,” *Harpers Magazine* (2004): 44. <http://harpers.org/archive/2004/09/0080197>.

⁴⁴ *Ibid.*, 48.

⁴⁵ Yousif, *Economic Policies in Iraq: Motivations and Outcomes*, 501.

⁴⁶ *Ibid.*, 502.

because policy makers ignored “reconstruction traps” of credible commitment, political economy, bureaucracy and fatal conceit. His specific argument against shock therapy was that since policy makers could never understand the entire economy, gradual reforms would invariably outperform simultaneous comprehensive changes. “In the case of Iraq, the CPA attempted to dictate the foundations of a free-market economy through its 100 Orders. The underlying assumptions were that these reforms would be effectively implemented and that they would sustain and operate in the desired manner. These assumptions neglected not only the reconstruction traps discussed above, but also the array of complementary informal institutions necessary for well-functioning markets.”⁴⁷

Starr has argued that creating viable mechanisms for monetary policy is a matter of governance. “Without a credible currency and minimal payments system, the government cannot make payments to employees or suppliers, prolonging problems of lack of cohesion and control.”⁴⁸ Starr's research examined case studies and econometric analyses of monetary reforms in nine transitioned countries and concluded that the correct policy prescription is context dependent. “What matters most is moving money out of the realm of powers and authorities used to the benefit of some parties to a conflict, and into the realm where it serves the common good.”⁴⁹

Collier, Hoeffler, and Soderbom have found positive correlation between economic growth and conflict reduction in transitioned countries.⁵⁰ Their study involved statistical analysis of 66 post-conflict cases through which they determined that economic recovery substantially contributes to risk reduction.⁵¹ Studies by Miguel et al. have also identified the importance of economic growth for risk reduction in Africa. Miguel et al. Ran regression analyses on a database of conflicts developed by the International Peace

⁴⁷ Christopher Coyne, “The Economic Reconstruction of Iraq”, 28.

⁴⁸ Martha Starr, “Monetary Policy in Post-Conflict Countries: Restoring Credibility” (Working Paper, American University, Washington DC, 2004): 4 <http://aladinrc.wrlc.org/bitstream/1961/4946/1/2004-07.pdf>.

⁴⁹ Ibid., 4.

⁵⁰ Paul Collier, Anke Hoeffler and Mans Soderbom, “Post-Conflict Risks,” *Journal of Peace Research* 45, no. 4 (2008): 3. <http://jpr.sagepub.com/content/45/4/461.full.pdf+html>.

⁵¹ Ibid., 15.

Research Institute of Oslo, Norway. The researchers found that GDP growth was significantly negatively related to the incidence of conflict in sub-Saharan Africa from 1981–1999.⁵²

C. CURRENCY REFORM

Prior to 2003, Baathist mismanagement, wars, and international sanctions crippled Iraq's economy. Compounding matters was the fact that Iraq's central bank and two state banks were systematically looted.⁵³ In 2003, two denominations of Iraqi dinars circulated within the economy. Since both “Saddam” and “Swiss” dinars featured the visage of a smiling Saddam Hussein, authorities feared that Iraq's currency would collapse after regime change. During the post-war chaos the presses, plates and paper for printing currency were stolen, leading to fears of widespread counterfeiting.⁵⁴ Given these circumstances, the CPA deemed it necessary to introduce a new currency in Iraq. Authorities contemplated alternatives ranging from simply adopting the “Swiss” version of the Dinar, dollarizing the economy or adopting a new currency with a floating exchange rate.⁵⁵ They argued that the authorities settled on a floating exchange rate currency in order to adjust to external shocks resulting from the price of oil, Iraq's primary export. But the preoccupation on external shocks allowed authorities to overlook the fact that there were no institutional barriers to prevent the “internal shock” of extensive government manipulation of Iraq's central bank in practice.⁵⁶ The authors promoted either a currency board or dollarization as superior alternatives to developing a central bank in Iraq.⁵⁷ Foote agreed with Hanke and Sekerke that dollarization would

⁵² Edward Miguel, Ernest Sergenti and Shanker Satyanath, “Economic Shocks and Civil Conflict: An Instrumental Variables Approach” (Working Paper, Working Paper, University of California, 2003): 727 http://elsa.berkeley.edu/~emiguel/pdfs/miguel_conflict.pdf.

⁵³ Looney, *Postwar Iraq's Financial System: Building from Scratch*, 136.

⁵⁴ Foote et al., “Economic Policy and Prospects in Iraq,” *Journal of Economic Perspectives* 18, no. 3 (2004): 60, <http://www.jstor.org/stable/pdfplus/3216806.pdf>.

⁵⁵ *Ibid.*, 60.

⁵⁶ Hanke and Sekerke, *Monetary Options for Postwar Iraq*, 8.

⁵⁷ *Ibid.*, 8–12.

have been a better option for real currency reform. But, he argued, political symbolism and security concerns convinced authorities to forgo the dollar and to create new dinars.⁵⁸

Looney claimed that while fixing the currency for a brief period during transition might have reduced extreme fluctuations in the exchange rate, pegging the Dinar to the dollar would have appeared imperial and produced interest-rate movements counter to Iraq's best interests.⁵⁹ Thus dollarization and the Swiss dinar were rejected for political reasons. To rid the currency of Saddam's legacy and signal Iraq's economic sovereignty the CPA decided on a new dinar with a "managed" floating currency regime to control the exchange rate. Under this arrangement, the CBI could retain the air of economic sovereignty and freely purchase U.S. dollars to weaken an excessively strong Dinar or sell dollars if the Dinar depreciates too rapidly.⁶⁰ Bathsheba Crocker also saw value in the new dinar. Although she opined that the CPA's banking laws were implemented top-down and did not reflect Islamic law, she believed that instituting a new Dinar was "one of the CPA's most successful reforms."⁶¹

D. DISCUSSION OF FINDINGS

There is no blueprint for broad economic reconstruction or consensus among economists about the best way to pursue macroeconomic reform during a transition.⁶² However, there was broad agreement that establishing a stable monetary system would be supportive of reconstruction.⁶³ Political considerations of the CPA played a major role in economic decisions. Each policy decision was surrounded by intense controversy and debate. Specific questions remain. What were the CPA's motivations for new floating

⁵⁸ Foote et al., *Economic Policy and Prospects in Iraq*, 61.

⁵⁹ Looney, *Postwar Iraq's Financial System: Building from Scratch*, 140-141.

⁶⁰ Ibid., 73.

⁶¹ Crocker, *Reconstructing Iraq's Economy*, 73.

⁶² Peter Murrell, "Evolution in Economics and in the Economics and in the Economic Reform of the Centrally Planned Economies," in *Emerging Market Economies in Europe* (Cambridge: Basil Blackwell, 1992): 5, <http://econweb.umd.edu/~murrell/articles/Evolution%20in%20Economics.pdf>.

⁶³ Ross Levine, "The Legal Environment, Banks, and Long-Run Economic Growth," *Journal of Money, Credit, and Banking* 30, no. 3 (1998): 605, http://www.econ.brown.edu/fac/ross_levine/finance/rlevine/publication/1998_jmcb_legal%20environ%20long%20growth.pdf.

currency? What were alternatives to an independent central bank ignored? Why did the CPA's opt for a rapid pace of reforms? The literature sufficiently examines mainly theoretical questions, offering both ideological and practical justifications for the CPA's decisions. The CPA's overall goal was developing a functioning financial system in Iraq. Without a functioning financial system, the transitioning government could neither secure loans nor pay workers, prolonging the lack of cohesion and control.⁶⁴ Thus, establishing a thriving and legitimate financial system is important to the post-war recovery. After all, what matters in an economy is not the wealth of a privileged few but the benefit of the common good.⁶⁵ Just how independent from government influence is the Iraqi central bank? How useful has the floating exchange rate been at controlling inflation? How many of the CPA's initial Central Bank reforms remain in Iraq? These questions are unanswered by the existing primarily theoretical literature. Therefore this thesis will conduct an empirical investigation of the CPA's macroeconomic reforms.

⁶⁴ Starr, *Monetary Policy in Post-Conflict Countries: Restoring Credibility*, 4.

⁶⁵ *Ibid.*, 5.

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IV. THE CPA

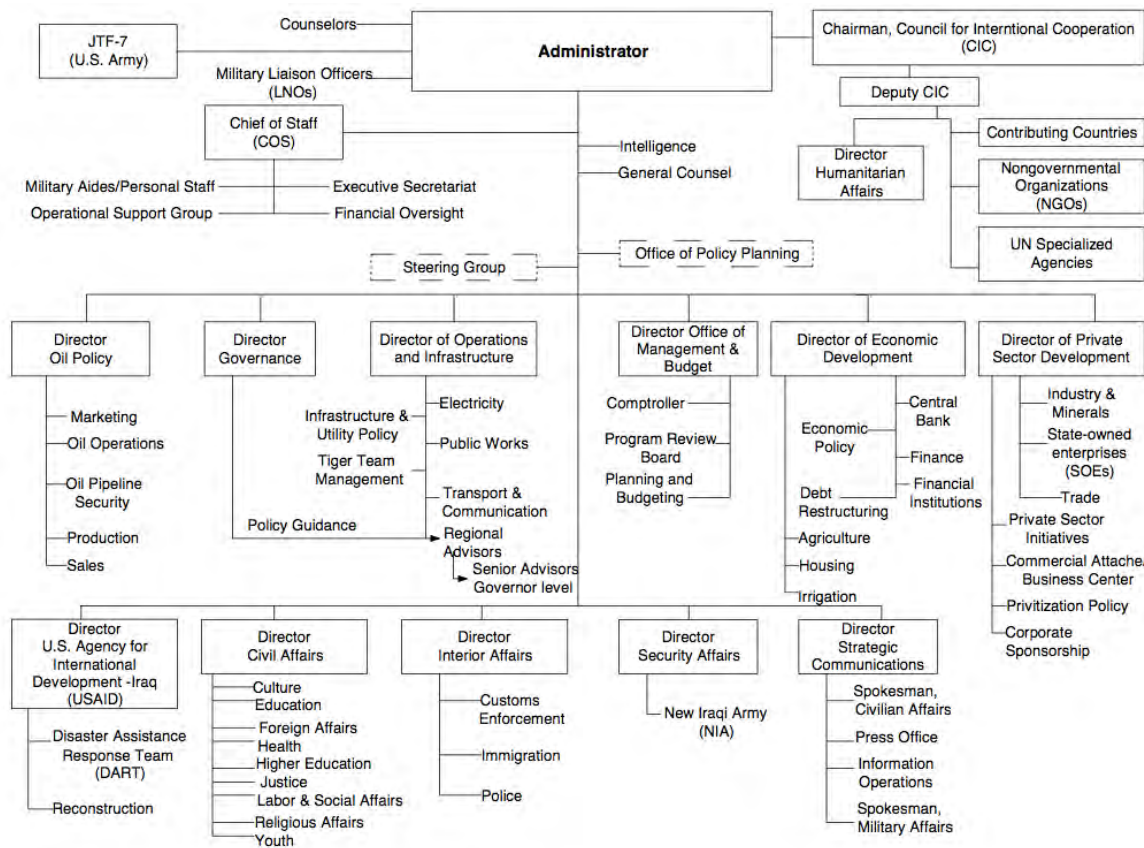


Figure 1. CPA Organization Chart⁶⁶

A. WHAT WAS THE CPA?

The Coalition Provisional Authority was established on April 9, 2003 with a mission to "restore conditions of security and stability, to create conditions in which the Iraqi people can freely determine their own political future, (including by advancing efforts to restore and establish national and local institutions for representative governance) and facilitating economic recovery, sustainable reconstruction and development."⁶⁷ The constitution and authority of the CPA was unclear. "The CPA was,

⁶⁶ Elaine Halchin, "The Coalition Provisional Authority (CPA): Origin, Characteristics, and Institutional Authorities", CRS Report to Congress, June, 2005, : 30, <http://www.dtic.mil/cgi-bin/GetTRDoc?AD=ADA458968&Location=U2&doc=GetTRDoc.pdf>.

⁶⁷ Ibid., 1.

at one and the same time, an element of the Defense department, a multinational organization, and a foreign government."⁶⁸ The United States Congress expressed initial concerns about the identity of the CPA.

It is unclear whether the CPA is a federal or a federal agency. Competing, though not necessarily mutually exclusive, explanations for how it was established contribute to the uncertainty about its status. The lack of an authoritative and unambiguous statement about how this organization was established, by whom and under what authority leaves open many questions, particularly in the areas of oversight and accountability. Some executive branch documents support the notion that it was created by the President, possibly as a result of the National Security Presidential Directive (NSPD)...The other possibility is that the authority was created by, or pursuant to, United Nations Security Council Resolution 1483 (2003).⁶⁹

Questions about whether the CPA was a federal agency or an international organization remained ambiguous and led to confusion about its organizational status and authority.⁷⁰ To resolve the issue of ambiguity, the U.S. Justice Department issued the following statement:

The CPA was created by the Commander of the Coalition Forces in Iraq, General Tommy Franks, United States Army, who was also the Commander of the U.S. Central Command. The establishment of the CPA by the Coalition was formally recognized by UNSCR [United Nations Security Council Resolution 1483]. Since the Coalition Forces had established and exercised actual authority of the territory of Iraq, under the laws of war and occupation, the authority of the defeated Iraqi regime of Saddam Hussein passed into the hands of the

⁶⁸ Ibid., 17.

⁶⁹ Adam Roberts, "The End of Occupation: Iraq 2004", The University Oxford Programme on the Changing Character of War, (2004):35, http://ccw.modhist.ox.ac.uk/publications/roberts_ICLQarticle_Iraq_2004.pdf.

⁷⁰ *Institutional Authorities*, CRS Report to Congress, (June, 2005); 9, <http://www.dtic.mil/cgi-bin/GetTRDoc?AD=ADA458968&Location=U2&doc=GetTRDoc.pdf>.

Coalition Forces. General Franks established the CPA under the laws of war to perform civil government functions in liberated Iraq during the brief occupation.⁷¹

Confusion about the CPA's organizational status and authority persisted despite the Justice Department declaration.

B. WHO WAS THE CPA?

In staffing the CPA, Paul Bremer attempted to recruit a cadre of experienced civilians from the United States. However, frequent staff turnovers and a lack of volunteers forced him to rely heavily on military appointments.⁷² Paul Bremer headed the CPA as lead administrator exercising supreme executive, legislative and judicial control. Bremer had the power to issue four types of decrees:⁷³

- Regulations – used to define the institutions and authorities of the CPA
- Orders – directives that had the power to alter existing Iraqi law. Most significantly, Orders 56 (Central Bank Order) and Order 43 that focused on reforming Iraq's banking industry
- Memoranda – expansions or modifications to CPA orders and regulations
- Public Notices – public relations messages that communicated the CPA intentions to the Iraqi people

C. IMPLICATION OF CPA'S STATUS

The CPA was organized into numerous staffs, line offices, senior advisors and other strategic units. The Office of Economic Policy, initially headed by Peter McPherson, oversaw the several ministries, including trade and the Iraqi central bank. During the initial months of operations, the CPA senior officials ran Iraqi's ministries under intense pressure to both quickly transfer power to Iraqis and to forestall the rise to power of spoilers, such the Iranian linked Islamist parties, the Supreme Council of the Islamic Revolution and the Da'wa Party.⁷⁴

⁷¹ Dobbins et al., "Occupying Iraq: A History of the Coalition Provisional Authority", Rand National Security Research Division, (2009):13, http://www.rand.org/pubs/monographs/2009/RAND_MG847.pdf.

⁷² Ibid., 14-15.

⁷³ Ibid., 16.

⁷⁴ Ibid., 43.

Another implication had to do with the legal authority of the CPA operations in Iraq in the absence of an elected Iraqi government. The worry was that elected officials would not only challenge the CPA's authority, but also overturn the CPA orders.⁷⁵ The CPA's first regulation highlighted the tenuous legal hold. "Regulations and Orders will remain in force until repealed by the Administrator or superseded by legislation issued by the democratic institutions of Iraq."⁷⁶ These survivability concerns were attenuated after Elections held in August 2003 installed Iraqi Governing Council made up of ministers who were vetted by the CPA.⁷⁷

⁷⁵ Ibid., 45

⁷⁶ Ibid., 28.

⁷⁷ Ibid., 45.

V. CPA MACROECONOMIC REFORMS

In 2003, at the Baghdad headquarters in Iraq's Green Zone, the CPA assessed the country's postwar condition. A total of three wars lasting almost a decade and 12 years of sanctions had reduced Iraq's per capita GDP to approximately \$1,000 USD. The CPA concluded that Iraq's reconstruction and long-term stability required rapid reform of the economy.⁷⁸ Reform goals included unifying the dual currencies in the northern and southern parts of the country, creating a credible monetary policy, and equipping Iraq's central bank with the tools necessary to control inflation.⁷⁹ Authorities believed that implementing these reforms at the rapid speed of Shock Therapy would prevent interference from Baathists and others interlopers. Iraq had been a cash economy under Saddam and few Iraqis had bank accounts. The two major banks, the Rafidain and Rasheed, had 340 branches that completely unconnected. "No branch would honor the checks of another branch, and the head honcho of the Central bank personally had to approve any transfer of funds across the border of Iraq. The banks were merely vaults for deposits of funds...Very few Iraqis had ever been in a bank."⁸⁰ On July 7th, 2003 Paul Bremer announced that a major component of reconstructing Iraq's macro-economy involved banking reform and unifying of Iraq's currency. Additional reforms involved creating an independent central bank with the capability of setting monetary policy including the rate of currency exchange.⁸¹

A. REFORM OF THE CENTRAL BANK OF IRAQ

CPA Bank Order 18 and 56 outlined the structure, objectives and independence of Iraq's Central Bank (CBI). The purpose of the CBI was to achieve domestic price stability, foster a competitive market-based financial system, and promote sustainable growth, employment, and prosperity in Iraq. With an initial staff of nearly 3,500, and

⁷⁸ Gray and Nell, *A New Currency for Iraq*, 19.

⁷⁹ Ibid., 5–6.

⁸⁰ Dave Oliver, "Restarting the Economy in Iraq," *Global Security* November, no. November (2003): 14, http://www.globalsecurity.org/military/library/congress/2007_hr/070206-oliver.pdf.

⁸¹ Gray and Nell, *A New Currency for Iraq*, 23.

three preliminary branches in Baghdad, Basra and Mosul, the CBI attempted to integrate the Kurdish central banks into a single Iraqi dinar and to coordinate the previously independent branches of the Rasheed and Rafidan banks. After several meetings with it head of the Kurdish central banks, the CPA reached agreements on Kurdish bank integration under the principle of one country, one currency, one central bank.⁸² The CPA also coordinated with leadership of the Rasheed and Rafidan banks to approve the New Dinar Currency Exchange Instructions and to identify the bank branches capable of becoming exchange sites for the new currency.⁸³ The CPA initially established reserve requirements on bank deposits as follows:⁸⁴

- Savings Accounts 5 percent
- Time Deposits 10 percent
- Current and Other Accounts 20 percent

Minimum rates banks must pay on deposits are:

- Savings Accounts 7 percent
- Six month time deposits 8 percent
- One year time deposits 9 percent
- Two year time deposits 10 percent

The maximum lending rates that banks could charge were formerly declared as follows:⁸⁵

- Short-term loans and advances 14 percent
- Medium-term (to five years) 15 percent
- Long-term (over five years) 16 percent

At the conclusion of the meetings between senior officials in Iraq's Ministry of Finance, the Central Bank in Baghdad, Kurdish leaders, and the CPA, all agreed that rapidly installing a single currency could underpin economic and political stability. Paul

⁸² Ibid., 26.

⁸³ Ibid., 114.

⁸⁴ David Munro, *Overview of the Iraqi Banking System: The State Owned Banks*, (2003): 5, http://www.izdihar-iraq.com/resources/bankingconf07/bankconf_pdfs/ref_ses5_munro_overview_iraqi_bankg_soes_032107.pdf.

⁸⁵ Ibid., 5.

Bremer contrasted his plan for rapid economic reforms with slow pace of economic reconstruction in Germany and the more recent case of Afghanistan where it had taken two years to replace that country's currency.⁸⁶

B EVALUATION OF CENTRAL BANK INDEPENDENCE

On October 14, 2003, Paul Bremer signed Order 43, authorizing the CBI as the sole authority in Iraq to issue legal tender.⁸⁷ Bank order 18 repealed the provisions of Saddam's earlier bank laws that had authorized the CBI to make loans to the Iraqi Government Ministries. Section two of Bank Order 18 prohibited the Ministry of Finance from interfering with the CBI's authority to set monetary and credit policy.⁸⁸ Thus legal central bank independence was instituted. But the measure of central bank independence required evaluating bank policy in practice. In 1992 Cukierman, Webb, and Neyapti introduced the widely accepted model and range of indicators for measuring central bank independence vis-à-vis inflation targeting. Their model included the examination of central bank law, a questionnaire, and an assessment of the Chief Operation Executive tenure.⁸⁹ Since this thesis does not include a survey of CBI governors, a modified version of the Cukierman, Webb and Neyapti model will be used to evaluate the independence of Iraq's central bank. This modified version of the model involves an assessment of the CBI laws according to Cukierman matrix, an examination of the tenure of the CBI chief executive and an evaluation of the CBI performance at targeting inflation.

1. Description of the Model

Four clusters of central bank characteristics are used to code legal independence. The clusters are:

⁸⁶ Gray and Nell, *A New Currency for Iraq*, 50.

⁸⁷ Ibid., 51.

⁸⁸ Ibid., 180.

⁸⁹ Alex Cukierman, Steven Webb and Bilin Neyapti, "Measuring the Independence of Central Banks and its Effect on Policy Outcomes," *World Bank Economic Review* 6, no. 3 (1992): 355, http://www.cedeplar.ufmg.br/economia/disciplinas/ecn933a/crocco/Operacao_governanca_Bancos_Centrais/CUKIERMANAWEBBNEYAPTImeas.pdf.

- Appointment, dismissal, and term of office of chief executive officer (CEO)
- Autonomy from executive branch for monetary policy formation-
- Objectives of the central bank
- Limitations on central bank lending to the private sector

The clusters are comprised of sixteen different legal variables that are coded on a scale of 0 (lowest level of independence) to 1 (highest level of independence). The detailed list of both classification and coding appear in table 1. The following criteria are used for coding the various levels of independence. The length in tenure of the CEO combined with the absence of the executive branch involvement in appointment and dismissal procedures indicate greater independence in the CEO dimension. Higher values for autonomy indicate greater central bank independence at policy formation. There are six possible ratings for central bank objectives. The ratings are coded to preference banks with a legal mandate for price stability as their singular goal. Thus a bank charter that states price stability for its objective is classified as more independent in this dimension compared to other stated objectives. A high measure for limitations on lending to the private sector indicates lower independence. In contrast, a high value for limits on lending to the public sector indicates greater independence in this cluster.

Table 1. Variables for Legal Central Bank Independence

| Variables for Legal Central Bank Independence | | | | |
|---|-------------------------------|-------------------------|--------|----------|
| Variable | | | | Coding |
| Number | | Description of Variable | Weight | |
| 1 | Chief Executive Officer (CEO) | | 0.2 | |
| | a. | Term in office | | |
| | | Over 8 years | | 1 |
| | | 6 to 8 years | | 0.75 |
| | | 5 years | | 0.5 |
| | | 4 years | | 0.25 |

| | | | | |
|---|---|---|------|-------------|
| | Variables for Legal Central Bank Independence | | | |
| | | Under 4 years or at the discretion of appointer | | 0 |
| | b. | Who appoints CEO? | | |
| | | Board of central bank | | 1 |
| | | A council of the central bank board, executive branch, and legislative branch | | 0.75 |
| | | Legislature | | 0.5 |
| | | Executive collectively (e.g. council of ministers) | | 0.25 |
| | | One or two members of the executive branch | | 0 |
| | c. | Dismissal | | |
| | | No provision for dismissal | | 1 |
| | | Only for reasons not related to policy | | 0.83 |
| | | At the discretion of central bank board | | 0.67 |
| | | At legislature's discretion | | 0.5 |
| | | Unconditional dismissal possible by legislature | | 0.33 |
| | | At executive's discretion | | 0.17 |
| | | Unconditional dismissal possible by executive | | 0 |
| | d. | May CEO hold other offices in government? | | |
| | | No | | 1 |
| | | Only with permission of the executive branch | | 0.5 |
| | | No rule against CEO holding other office | | 0 |
| 2 | Policy | | 0.15 | |
| | | | | |
| | a. | Who formulates monetary policy? | | |
| | | Bank alone | | 1 |
| | | Bank participates, but has little influence | | 0.67 |
| | | Bank only advises government | | 0.33 |
| | | Bank has no say | | 0 |
| | b. | Who has final word in resolution of conflict? | | |
| | | The bank, on issues clearly defined in the law as its objectives | | 1 |

| | | | | |
|---|---|---|------|------------|
| | Variables for Legal Central Bank Independence | | | |
| | | Government, on policy issues not clearly defined as the bank's goals or in case of | | |
| | | conflict within bank | | 0.8 |
| | | A council of the central bank, executive branch and legislative branch | | 0.6 |
| | | The legislature, on policy issues | | 0.4 |
| | | The executive branch on policy issues, subject to due process and possible | | |
| | | protest by the bank | | 0.2 |
| | | The executive branch has unconditional priority | | 0 |
| | c. | Role in the government's budgetary process | | |
| | | Central bank active | | 1 |
| | | Central bank has no influence | | 0 |
| 3 | Objectives | | 0.15 | |
| | | Price stability is the major or only objective in the charter, and the central bank has the final word in case of conflict with other government objectives | | |
| | | Price stability is the only objective | | 0.8 |
| | | Price stability is one goal, with other compatible objectives, such as a stable | | |
| | | banking system | | 0.6 |
| | | Price stability is one goal, with potentially conflicting objectives, such as full | | |
| | | employment | | 0.4 |
| | | No objectives stated in the bank charter | | 0.2 |
| | | Stated objectives do not include price stability | | 0 |
| 4 | Limitation on lending | | | |
| | a. | Advances (limitation on non-securitized lending) | 0.15 | |
| | | No advances permitted | | 1 |
| | | Advances permitted, but with strict limits (e.g., up to 15 percent of government | | |
| | | revenue) | | .67 |

| | Variables for Legal Central Bank Independence | | | |
|--|---|---|-------|-------------|
| | | Permitted, and the limits are loose (e.g., over 15 percent of government revenue) | | 0.33 |
| | | No legal limits on lending | | 0 |
| | b. | Securitized lending | 0.1 | |
| | | Not permitted | | 1 |
| | | Permitted, but with strict limits (e.g, up to 15 percent of government revenue) | | 0.67 |
| | | | | |
| | | Permitted, and the limits are loose (e.g., over 15 percent of government revenue) | | 0.33 |
| | | No legal limits on lending | | 0 |
| | c. | Terms of lending (maturity, interest, amount) | 0.1 | |
| | | Controlled by the bank | | 1 |
| | | Specified by the bank charter | | 0.67 |
| | | Agreed between the central bank and executive | | 0.33 |
| | | Decided by the executive branch alone | | 0 |
| | d. | Potential borrowers from the bank | 0.05 | |
| | | Only the central government | | 1 |
| | | All levels of the government (state as well as central) | | 0.67 |
| | | Those mentioned above and public enterprises | | 0.33 |
| | | Public and private sector | | 0 |
| | e. | Limits on central bank lending defined in | 0.25 | |
| | | Currency amounts | | 1 |
| | | Shares of central bank demand liabilities or capital | | 0.67 |
| | | Shares of government revenue | | 0.33 |
| | | Shares of government expenditures | | 0 |
| | f. | Maturity of loans | 0.025 | |
| | | Within 6 months | | 1 |
| | | Within 1 year | | 0.67 |
| | | More than 1 year | | 0.33 |
| | | No mention of maturity in the law | | 0 |
| | g. | Interest rates on loans must be | 0.025 | |

| Variables for Legal Central Bank Independence | | | | |
|---|----|---|-------|----------|
| | | Above minimum rates | | 1 |
| | | At market rates | | 0.75 |
| | | Below maximum rates | | 0.5 |
| | | Interest rate is not mentioned | | 0.25 |
| | | No interest on government borrowing from the central bank | | 0 |
| | | | | |
| | | Central bank prohibited from buying or selling government securities in the | | |
| | h. | primary market? | 0.025 | |
| | | Yes | | 1 |
| | | No | | 0 |

Note: The ranking of each criterion indicates the degree of independence of the central bank- the higher the code, the more independent the central bank. If the bank law does not mention specific criteria the variable is coded on the impression from reading the law in its entirety.⁹⁰

2. Aggregating the Legal Variables

The data on the 16 legal variables listed in Table 1 are aggregated into eight legal variables. The weighted mean of the four variables capturing the appointment and term of office of the central bank governor are aggregated into a single variable of CEO. The three variables under policy formation were weighted and aggregated into a single mean. The objectives variable is treated separately as were the first four variables under limits to lending. The last four variables in the limits to lending cluster were averaged with equal weights into one variable. In coding the degree of Iraq's Central Bank independence the length of the bank governor was assessed as 1. Central bank independence is directly correlated with the legal term of office for the bank governor. Independence is also greater for a bank where the government has little legal authority in appointing or dismissing the governor. Dr. Sinan Al-Shabibi has been Iraq's Central Bank governor since 2003. Moreover Article 13 of Iraq's central Bank Law stipulates that the executive

⁹⁰ Central Bank of Iraq, "Central Bank of Iraq: Annex A," (2004): 1, http://www.cbi.iq/documents/CBILAW-EN_f.pdf.

branch of Iraq's government has no legal authority to appoint or dismiss the Central Bank Governor.⁹¹ Formulating banking policy in Iraq is, by law, the exclusive domain of the CBI. Thus, the policy variable was coded as 1. In coding the objective of Iraq's Central Bank, there are six possible ratings, with prominence given to price stability. Article 3 of the CBI Law lists price stability as only one among other goals, including fostering and maintaining a stable and competitive market-based financial system, and promoting sustainable growth, employment, and prosperity in Iraq.⁹² Thus the rating for the category called central bank objective was 0.6. Tight limits on lending to the public sector signals increased bank independence. Since Article 26 authorizes unlimited CBI lending to government-owned commercial banks, the coding for this variable was .38.⁹³

3. Result of Study

The aggregated and weighted score of the CBI independence was 0.64. This places the CBI's independence on par with that of industrialized countries like Switzerland (.64) and Germany (.69).⁹⁴

Table 2. Legal central Bank Independence 1980–1989

| Economy | Legal Central Bank Independence | Average Inflation Rate |
|---------------|---------------------------------|------------------------|
| Germany | 0.69 | 3 |
| Switzerland | 0.64 | 3 |
| Austria | 0.61 | 4 |
| Denmark | 0.50 | 5 |
| United States | 0.48 | 6 |

⁹¹ Ibid., 13.

⁹² Ibid., 9.

⁹³ Ibid., 21.

⁹⁴ Cukierman, Webb and Neyapti, *Measuring the Independence of Central Banks and its Effect on Policy Outcomes*, The World Bank Economic Review, Vol 6. No 2 : (1992): 362, http://www.cedeplar.ufmg.br/economia/disciplinas/ecn933a/crocco/Operacao_governanca_Bancos_Centrais/CUKIERMANAWEBBNEYAPTImeas.pdf.

This finding is consistent with empirical studies on Central Bank's performance that concluded that independent central banks were better at targeting inflation.⁹⁵ The finding is also consistent with studies showing a strong correlation between bank policies that focused on controlling inflation and bank independence.⁹⁶ A summary of inflation in Iraq since 1980 depicts the following trend:⁹⁷

Period inflation average

- 1980–1995 10.6 percent
- 1986–1990 18.6 percent
- 1991–1995 250 percent
- 1995–2003 12.8 percent

Policies put in place after 2003 set the dinar exchange rate as the main instrument for the CBI control of the inflation.⁹⁸ But Iraq's inflation from 2004 to 2006 was 31.7, 31.6 and 64.8 respectively.⁹⁹ Iraq's period of high inflation persisted because the Central Bank had kept the dinar exchange rate of 1460 dinar to U.S. dollar as determined by the CPA. After 3 years of inaction, the CBI enacted policy to allow the dinar to appreciate against the dollar.¹⁰⁰ The change in dinar exchange rate decreased Iraq's inflation and has calmed inflation to single digits since 2007. This experience in Iraq is consistent with the recent research on the correlation of central banks independence with effectiveness at targeting inflation.

⁹⁵ Tian Huang, "Effects of Central Bank Independence Reforms on Inflation in Different Parts of the World" (University Research, Dalarna University, 2011): 18, <http://dalea.du.se/theses/archive/0f3b3125-c156-460d-a702-9d840027169f/2ed7c824-a192-4bfe-ab7e-dbce8d636311.pdf>.

⁹⁶ Cukierman, Webb and Neyapti, *Measuring the Independence of Central Banks and its Effect on Policy Outcomes*, 357.

⁹⁷ Republic of Iraq Ministry of Planning, *National Development Plan for Years 2010–2014*, 56.

⁹⁸ Steve Hanke and Matt Sekerke, "Iraq's Botched Currency Reform," *Central Banking Publications* (2004): 42, <http://www.cato.org/research/articles/hanke-0402.pdf>.

⁹⁹ International Monetary Fund, "Iraq Statistical Appendix," no. July (2007): 7, <http://www.imf.org/external/pubs/ft/scr/2007/cr07294.pdf>.

¹⁰⁰ Hanke and Sekerke, *Iraq's Botched Currency Reform*, 42.

C. REFORM OF THE IRAQI DINAR

As mentioned earlier, the CPA had three options for possible currency reforms:¹⁰¹

- Dollarization -The outright adoption of the U.S. currency
- A currency board - The dinar is backed one for one with U.S. reserves
- A managed float - The dinar's value is set relative to major currencies

By mid-October 2003, less than three months after the fall of Saddam, officials introduced a new Iraqi Dinar. The officials based their decision on the following five assumptions: 1) that a single currency would achieve the political objective of unifying the country; 2) that the technology in the new currency would be harder to counterfeit; 3) that monetary policy supporting the new currency would end past inflationary policies; 4) the increased supply of new notes would satisfy the demand for a broader range of denominations; and 5) that Iraqis would see a “fresh start” in a currency without the visage of Saddam Hussein.¹⁰² A major disadvantage of the Saddam dinars was the ease of counterfeiting due to the use of standard offset printing on wood-based paper and primitive security features. The Swiss dinars in the north presented a different set of problems. By 2003 those notes were at least 15 years old and they were in inadequate supply to finance transactions so they could not replace the Saddam dinar. This scarcity was in part to blame for the relative appreciation of the Swiss dinar against both the Saddam dinar and the U.S. Dollar. Since Iraq did not have the technology to print new dinars the central bank had to find a currency printer with secure technology and volume capacity for new dinar notes.¹⁰³

The decision to remove Saddam’s image from Iraq’s dinar was easy. The CPA believed that further deliberations on the design of the new dinar could take up to 18 months, which would have been too long. Yet, Paul Bremer judged that the occupying powers should not be perceived to have imposed a new currency on Iraq. After discussions with officials from the CBI, Acting Governor Faleh Salman agreed that his

¹⁰¹ Nouriel Roubini and Brad Setser, “Should Iraq Dollarize, Adopt a Currency Board Or Let its Currency Float? A Policy Analysis,” *Council of Foreign Relations*, no. May (2003): 4, <http://www.cfr.org/economics/should-iraq-dollarize-adopt-currency-board-let-its-currency-float/p5994>.

¹⁰² Gray and Nell, *A New Currency for Iraq*, 41–42.

¹⁰³ *Ibid.*, 39–40.

signature should be incorporated in the design elements. Other members of the CBI concluded that re-issuing the old illustrations from the pre-1990 Swiss dinar would be popularly accepted since they predated the Saddam dinar and “those designs reflect[ed] Iraq’s culture, history and contemporary life.”¹⁰⁴



Figure 2. Saddam Dinar.¹⁰⁵

¹⁰⁴ Ibid., 42.

¹⁰⁵ “Dinar Set,” Sarah Rose, <http://www.sahararose.net/dinarset.html>.

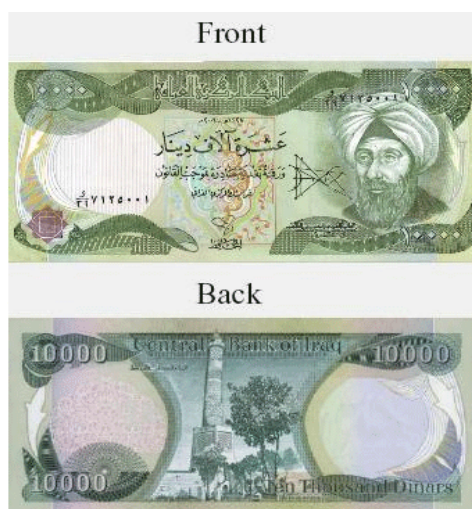


Figure 3. New Iraqi Dinar.¹⁰⁶

The 10,000 Dinar front depicts the image of Abu Ali Hasan Ibn al-Haitham who was born in 965 A.D. in Basra and was a prominent scientist and mathematician during the ‘Golden Age’ of Muslim civilization. Al-Haitham wrote over 200 books on matters such as optics, algebra and geometry and he gave the first modern explanation of human vision. The back of the 10000 Dinar depicts the Hadba Minaret at the Great Nurid Mosque in Mosul that was built 1172 A.D.¹⁰⁷

Table 3. Total Dinar Banknote order created during the currency exchange.

| Denomination | Notes (millions) | Value (billions) | Percent of volume | Percent of value |
|--------------|------------------|------------------|-------------------|------------------|
| 50 | 276 | 13.8 | 8.49 | .11 |
| 250 | 1,108 | 277 | 34.09 | 2.2 |
| 1000 | 881 | 881 | 27.11 | 7 |
| 5000 | 415 | 2,075 | 12.77 | 16.48 |
| 10000 | 327 | 3,270 | 10.06 | 25.97 |
| 25000 | 243 | 6,075 | 7.48 | 48.25 |
| Total | 3,250 | 12,591.8 | 100 | 100 |

¹⁰⁶ “Iraq Currency,” Iraq News World, <http://www.iraqnewsworld.com/iraq-currency.html>.

¹⁰⁷ Gray and Nell, *A New Currency for Iraq*, 95.

The CPA promulgated a public information campaign that involved strategic use of print TV and radio outlets. The campaign was executed in two phases. Phase one focused on informing the Iraqi public about the basic facts and rationale for the currency exchange. Phase two of the information campaign involved revealing details about the design of the new dinar bank notes in order to familiarize Iraqis about the currency.¹⁰⁸

The CPA's media strategy included:

1. A traveling roadshow targeting Iraqi government officials
2. Posters and handbills detailing the currency exchange locations, timing and dinar conversion rates
3. Television and radio public service announcements

In carrying out the roadshow, CPA officials visited all 17 governorates outside Baghdad. "Often the meetings were with the Governing Council for the Governorate, or local district council, and ranged in size from 250 community leaders in Mosul to 5 local businessmen in An Nasiriyah. Local journalists were usually invited to attend the roadshow events, and time was set aside for press events around the presentations."¹⁰⁹ The CPA relied on coalition troops to distribute approximately two million handbills and 270,000 posters in Arabic and Sorani Kurdish dialect. "The troops and contacts charged with distributing the handbill face-to-face were supplied with talking points—a "Q and A" style script—to help answer questions members of the public might have."¹¹⁰ Due to time constraints, the CPA declined to translate handbills into other languages spoken in Iraq. For the television and radio campaign the CPA set up an Arabic language facility under the Iraqi Media Network and broadcasted two news programs daily. The message promulgated during these broadcast matched the script of the handbill and the roadshow. "Although the Iraqi Media Network was not universally credible, its wide reach and the frequency of the message helped to raise awareness of the currency exchange."¹¹¹

In order to not disrupt Iraq's financial markets, the CPA privately contacted several international currency printers to find a competitive price and a capable supplier

¹⁰⁸ Ibid., 80.

¹⁰⁹ Ibid., 80–81.

¹¹⁰ Ibid., 81.

¹¹¹ Ibid., 83.

for Iraq's new banknotes. Seemingly minor details such as whether to use polymer or paper notes challenged the administration due to budgetary constraints (polymer costs more than paper). Other deliberations involved whether a future administration would redesign the currency and whether inflation might produce the need for different denominations to be printed.¹¹² The officials concluded that the new dinar notes would be 100 percent cotton paper with watermark security threads, and feature lithographic intaglio front and back printing. The British firm De La Rue (DLR) received the no-bid printing contract. DLR's used a consortium of international printing facilities and suppliers including DLR plants in Sri Lanka, Kenya, Malta and the UK. Simultaneous printing at the distributed plants greatly accelerated the production of the new banknotes.¹¹³

The CPA involved the CBI and the International Monetary Fund (IMF) in determining the standard range of currency denominations. The IMF relied on the experience of changing currencies in the Former Soviet Union in the early 1990s to guide the planning of dinar exchange.¹¹⁴ The advice from the IMF was to base the frequency of the denominations on the daily wage. Unfortunately, in 2003 there was no reliable labor market data on wages in Iraq. "The average public sector salaries of around 180,000 dinars per month or 3,000 dinars per day [and] reported daily laborer rates of 2,000 dinars a day implied that the most popular note should be in the range of 300–600 dinars."¹¹⁵ However, administrators decided on a lower-denomination frequency of 1,000 dinars and that the 250 dinar note should be the most common denomination.¹¹⁶ The new denominations included 50, 250, 1,000, 5,000, 10,000, and 25,000 dinar notes. The assumption that there were 4.5 trillion dinars in circulation (around 2.5 billion USD) led the administrators to conclude that an initial production of 6 trillion new dinars would

¹¹² Ibid., 39–40.

¹¹³ Ibid., 41.

¹¹⁴ Richard Abrams and Hernan Cortes-Douglas, "Introduction of a New National Currency: Policy, Institutional and Technical Issues" (Working Paper, IMF Working Papers no 93/49, IMF, 1993): 2, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=883512.

¹¹⁵ Gray and Nell, *A New Currency for Iraq*, 47–48.

¹¹⁶ Ibid., 49.

create a sufficient buffer stock (approximately 30 percent of the required note issue). Although the buffer stock was on the low side, it was all that the DLR could produce in time for the planned currency exchange.¹¹⁷

The CPA set the swap rate at 1:1 between Iraq's new Dinar and the Saddam Dinar. Reaching an agreement on the exchange rate for the Swiss Dinar used in the Kurdish area was more contentious. A high exchange rate would produce the short-term benefit of increased wealth in the Kurdish regions but reduced competitiveness over time. An artificially low exchange rate would engender the feeling of impoverishment. "After extensive economic modeling, it was decided to set the swap rate at 150:1, substantially below the market rate, in order to avoid recreating the East German problem, where setting the Ostmark swap rate for the Deutsche Mark too high had made the economy uncompetitive and been responsible for years of low growth and high unemployment."¹¹⁸ Once the New Dinars were printed the CPA had to tackle the logistics and security arrangements for currency distribution.

The logistical difficulty of delivering the new dinars and collecting the old currency in war-torn Iraq was compounded by the security arrangements required for protecting the currency during transition and at bank locations. CPA officials coordinated convoy teams of coalition military forces and private contractors to clear routes and shuffle the currency from distribution hubs to the banks and back. In the Baghdad region the CPA contracted armored cars to deliver and exchange dinars. Since the Kurdish region remained under the security of an enforced no-fly zone, authorities used air transport to the Suleimaniyah and Irbil airports to exchange currency in that region.¹¹⁹

Security at Iraqi banks and other exchange locations was manpower and time intensive. The CPA estimated that security at the 244 exchange locations required 20 personnel over a 24-hour period. Given the enormous demand, it was clear to officials

¹¹⁷ Ibid., 45.

¹¹⁸ Ibid., 46.

¹¹⁹ Ibid., 89.

that coalition military personnel did not have the capacity for that security task. Given the additional demands that the currency security force have a national presence and authority to detain and arrest, officials concluded that the most suitable choice was the Iraqi Police.¹²⁰ The CPA divided the currency exchange operation into three phases: Phase 1) positioning phase based on identifying and preparing the hubs and exchange locations beginning in October 2003; Phase 2) dinar resupply and pickup; and Phase 3) operation closedown which involved collecting remnants of old currency and transitioning bank operations to CBI control. The CPA dinar exchange ended in February 2004 when the CBI assumed authority over the remaining elements of the operation.¹²¹

D. EVALUATION OF CURRENCY EXCHANGE

Once the CPA made the decision that creating a new dinar was the optimal choice for fixing Iraq's currency issues they had to design and print the currency, redenominate notes, set the exchange rate and finally swap the currency under extreme conditions of insecurity. The CPA successfully coordinated with Iraq's CBI and the IMF on the design of the new dinar, and how to integrate the competing dinars circulating in the economy. The decision to use the Iraqi Police for point security at bank locations was controversial. In 2003 the Iraqi Police was poorly trained, inadequately staffed and not trusted. Using the police for such an important mission was a huge gamble but it paid off. All aspects of the currency exchange were successful at achieving their political and economic goals. The creation of a new Iraqi dinar based on the pre-Saddam note broke the psychological link between the Iraqis and Saddam's regime. And any economic restart in Iraq was preconditioned on a stable national currency under an Iraqi Central Bank with the authority to target inflation and manage exchange rates. The violence that existed in Iraq in 2003 made all forms of transportation difficult, especially trafficking currency for the dinar exchange. The CPA successfully flew 2,600 tons of new currency, using 41 sorties into Baghdad. They then managed hundreds of fixed-wing currency transports and road convoys throughout North and South Iraq using Iraqi police, coalition military and

¹²⁰ Ibid., 91.

¹²¹ Ibid., 94–148.

contract guards. The fact that there was no reported security incident involving the currency exchange operation only proves the remarkable success of that mission.¹²²

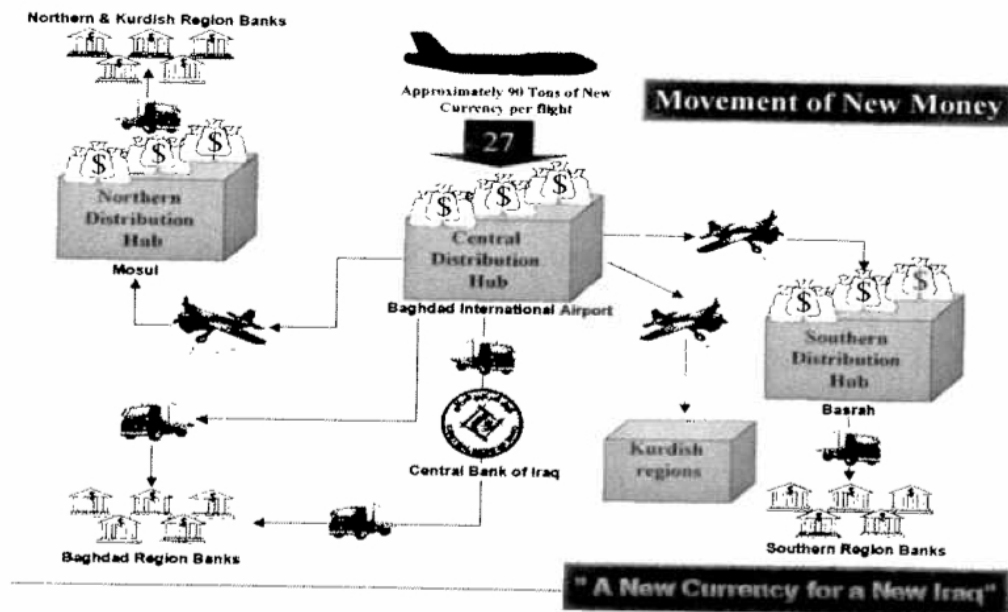


Figure 4. Positioning the New Currency¹²³

Security was another concern that motivated the hasty pace of economic reforms. The planners were cautious to prevent the extensive looting and bank robberies that occurred during the post-war looting. Thus the currency exchange was divided into three rapid-fire operational phases; positioning, resupply/pickup, and closedown. The positioning phase took place from October 4 to October 15. During this phase new dinars were positioned at regional hubs.

¹²² Ibid., 8.

¹²³ Gray and Nell, *A New Currency for Iraq*, 94.

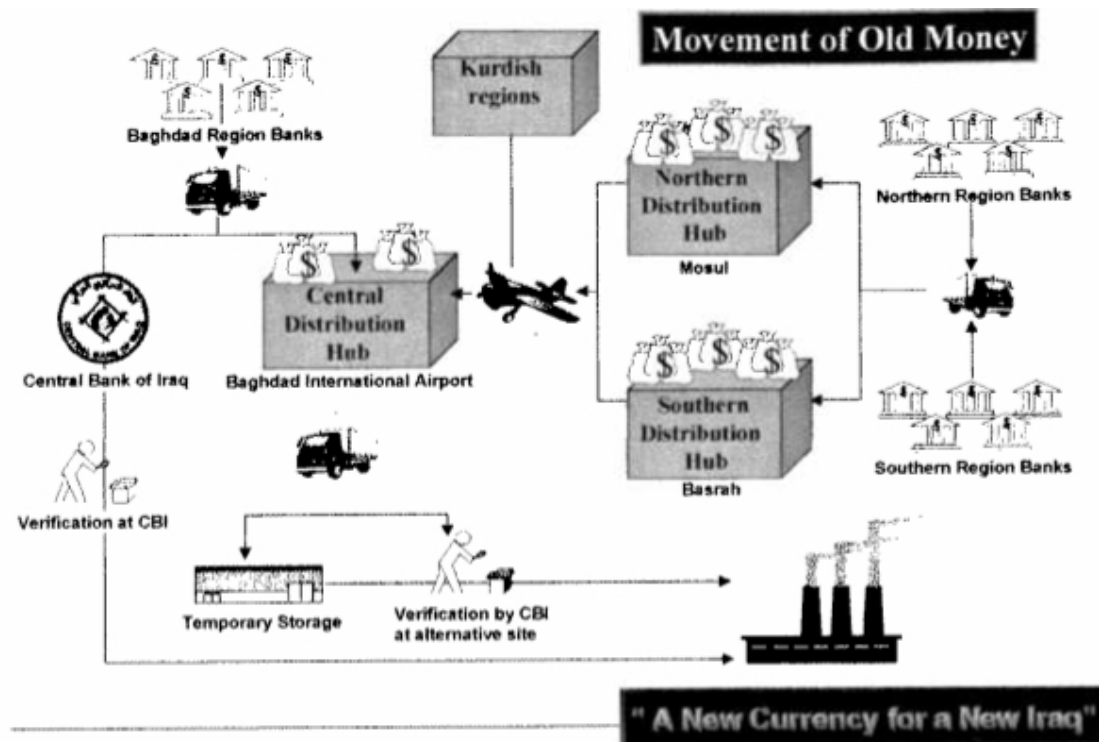


Figure 5. Resupply and Pickup¹²⁴

E. SHOCK THERAPY AND THE WASHINGTON CONSENSUS

Within the space of 14 months the CPA issued 100 administrative orders that reset operations within Iraq including its economy. The political motivation behind this shock therapy was to introduce reforms quickly to circumvent interference from Baathist and others members of the old guard.¹²⁵ “The reforms clearly incorporate much of the agenda originally laid out in the Washington Consensus. The main thrust of the Washington Consensus is a set of actions which, if taken at an early stage of transition, should facilitate a smooth evolution into the world economy.”¹²⁶ The set of actions outlined by the Washington Consensus calls for privatization, cuts in fiscal deficits and

¹²⁴ Ibid., 59.

¹²⁵ Paul Bremer, *My Year in Iraq* (New York: Simon & Schuster, 2005), 41.

¹²⁶ Robert Looney, “The Viability of Economic Shock Therapy in Iraq,” *Challenge* 47, no. 5 (2004): 3, http://faculty.nps.edu/relooney/Rel_Challenge04.pdf.

subsidies, removal of trade barriers and the free flow of international capital.¹²⁷ The CPA Orders 18, 20, 40, 43, 74 and 94 liberalized Iraq's monetary system. Orders 39, 46, and 51 sought to immediately privatize state owned enterprises.¹²⁸

The treat of resistance to the economic reform was a strong motivator for shock therapy. Resistance to economic reform takes a variety of forms, some constructive and beneficial while others are destructive and characterized by elites who enjoyed privileged arrangements with the existing regime. The absence of a strong civil society, mature institutions and political parties in Iraq aroused the fear of the destructive resistance to economic reform. The resisters were capable of blocking reforms from being introduced, preventing implementation or distorting the reform process in self-serving ways.

The CPA's program of shock therapy also faced legal challenges under The Hague Regulation and Geneva Convention. According to Article 43 of The Hague Regulations an occupying power should "restore, and ensure, as far as possible, public order and safety, while respecting, unless absolutely prevented, the laws in force in the country."¹²⁹ Article 64 of the Geneva Convention further constrains the rule making authority of the occupying power to enacting "provisions which are essential to enable the Occupying Power to fulfill its obligations."¹³⁰ Thus, critics have argued that the CPA's economic reforms that were implemented under shock therapy went beyond the limits of both the Hague regulation and the Geneva Convention. "Nowhere does permission for the restructuring of the Iraqi economy, for introducing WTO compliant policies or for passing laws that propel the economy into reliance upon foreign capital feature in any of the UN resolutions that gave legitimacy to the CPA."¹³¹ Others had

¹²⁷ Kaushik Basu, "Globalization and the Politics of International Finance: The Stiglitz Verdict," *Journal of Economic Literature* 41, no. September (2003): 5, <http://ideas.repec.org/a/aea/jeclit/v41y2003i3p885-899.html>.

¹²⁸ Dave Whyte, "The Crimes of Neo-Liberal Rule in Occupied Iraq," *The British Journal of Criminology* 47, no. 2 (2006): 180, <http://bjc.oxfordjournals.org/content/47/2/177.abstract>.

¹²⁹ Edmund Schwenk, "Legislative Power of the Military Occupant Under Article 43, Hauge Regulations," *The Yale Law Journal Company* 54, no. 2 (1945): 1, <http://www.jstor.org/stable/pdfplus/792772.pdf?acceptTC=true>.

¹³⁰ Whyte, *The Crimes of Neo-Liberal Rule in Occupied Iraq*, 182.

¹³¹ *Ibid.*, 183.

argued that although the CPA's economic reform process did not formally include ordinary Iraqis in decision-making, the involvement of Iraq's governing Council ensured that decisions would prove lasting and effective.¹³²

F. EVALUATION OF SHOCK THERAPY

The question of CPA legal authority in Iraq would suggest that orders initiated by the CPA and the transitional government would be revoked or substantially modified by an independent government. Substantial modifications to the CPA orders would corroborate the charge that shock therapy's failure to solicit input from local Iraqis. Yet a comparison of the CPA Central Bank Law implemented in 2003 and the current CBI Bank Law clearly indicates no significant changes. In fact the CPA orders that structured the CBI and outlined its major macroeconomic policies since 2003 have remained unchanged in both letter and spirit. In spite of these reforms the economic situation in Iraq remains unremarkable. "As a matter of fact, since the war ended, the implemented economic measures and the actual expenditures have neither increased domestic production and productive employment nor improved the living standards of the majority of the people."¹³³ Given the continued poor performance of Iraq's economy it begs the question why officials have not deviated from the Washington Consensus. One probable explanation for why the Iraqi authorities have resisted interfering with the macroeconomic system imposed under the CPA's occupation is that the dominance of oil revenues in the Iraqi economy.

¹³² Haider Hamoudi, "Money Laundering Amidst Mortars: Legislative Process and State Authority in Post-Invasion Iraq," *Transnational Law and Contemporary Problems* 16 (2007): 524–553, http://works.bepress.com/cgi/viewcontent.cgi?article=1003&context=haider_ala_hamoudi.

¹³³ Looney, *The Viability of Economic Shock Therapy in Iraq*, 8.

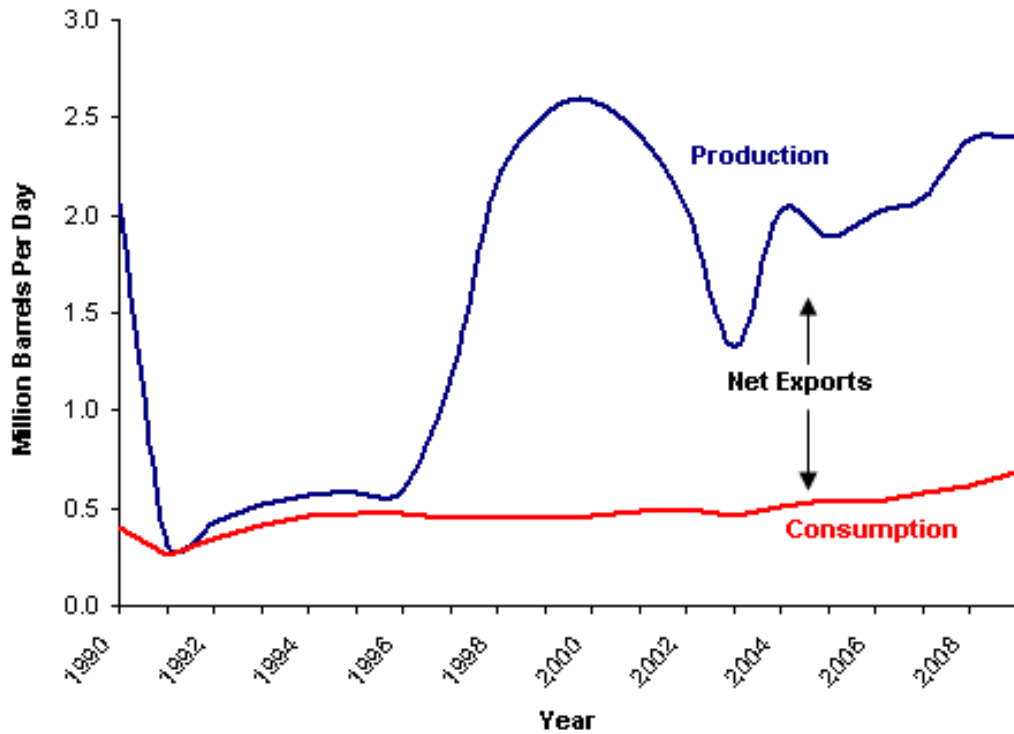


Figure 6. Iraqi Year to Date Revenue from Oil Exports ¹³⁴

The argument for sequencing economic reforms had merit especially given the fact that Iraq's economy continued to suffer from a combined political and economic challenges. Ironically, it might have been the government's over reliance on oil exports for funding operations that has both retarded economic development and also created the space for developing independent macroeconomic institutions.

¹³⁴ Energy Administration Association, "Iraq Country Analysis Briefs", <http://www.eia.gov/emeu/cabs/Iraq/pdf.pdf>.

VI. CONCLUSION

This thesis measured three aspects of the CPA's macroeconomic reforms for transitioning Postwar Iraq; the degree of CBI independence; the success of the currency exchange; and whether the program of shock therapy weakened macroeconomic reforms. The premise behind implementing liberal economic reforms in Iraq was that creating a market-oriented economy would increase internal stability and would integrate Iraq into the global economy. Moreover, an integrated Iraqi government would be less likely to engage in hostile action against its own population or its neighbors. Experts agreed that transforming Iraq's banking system would be an important milestone for the post war reconstruction. The consensus view was that an Iraq with an independent central bank would be more credible at implementing rational economic policies such as controlling inflation.¹³⁵ Although CPA Order 56 legislated CBI independence, there existed no empirical measure of the bank's independence from the executive branch of the government. This thesis measured the actual degree of CBI independence using the most widely accepted measure established by Cukierman, Webb, and Neyapti. According to this measurement Iraq's central bank rated an independence score of .64. This thesis also examined the CBI effectiveness at targeting inflation, which is another indicator of central bank independence. Between 1980 and 2003 Iraq's average inflation rate remained in the double digits, which suggest that the Central Bank independence and credibility was quite low.¹³⁶ In 2006, CBI authorities increased the dinar exchange rate by 20 percent to generate dinar demand.¹³⁷ That move resulted in the decline of inflation from a high of 76.6 percent in August 2006 to 4.7 percent in December 2007. Currently Iraq's rate of inflation remains in single digits.¹³⁸

¹³⁵ Huang, *Effects of Central Bank Independence Reforms on Inflation in Different Parts of the World*, 17.

¹³⁶ Republic of Iraq Ministry of Planning, *National Development Plan for Years 2010–2014*, 56.

¹³⁷ David Grigorian and Udo Kock, "Inflation and Conflict in Iraq: The Economics of Shortages Revisited," *International Monetary Fund*, no. July (2010): 6, <http://www.imf.org/external/pubs/cat/longres.cfm?sk=24035.0>.

¹³⁸ Deepa Dhume, "Five Priorities for Economic Reform in Iraq: Encouraging Growth Amid Security Challenges" (Draft, Harvard University, Boston, 2008): 5, <http://www.people.fas.harvard.edu/~dhume/FivePrioritiesIraq.pdf>.

The dinar consolidation unified Iraq's dual monetary system. Moreover, the new bank notes helped erase Saddam's legacy of economic incompetence. The transition to an independent central bank introduced professional management of Iraq's economy. But broad economic development remains elusive in Iraq. At present, crude oil satisfies over 90 percent of Iraq's domestic energy consumption and oil exports generate over 90 percent of Iraq's government revenue.¹³⁹ "Revenues from the sale of oil resources are the engine of Iraq's national economy and the lifeblood of its national budget. Iraq's state-owned oil production and marketing system ensures that revenue from the export and sale of Iraqi oil accrues to the Iraqi government, and the Iraqi people's elected representatives are now responsible for administering that revenue to meet the country's considerable development needs."¹⁴⁰ The persistence of poor economic performance begs the question as to why the CPA's macroeconomic reforms persist. The dominance of oil revenue in funding Iraq's government operations may explain why politicians have largely ignored macroeconomic policy. The dominance of oil interests overshadows the domestic economy and directs government attention away from central banking policy. Since 2003 the Iraqi government has largely ignored CBI independence but has issued several new decrees for increased authority over the oil ministries.¹⁴¹ Central bank independence should persist as long as oil exports continue to produce annual budget surpluses in Iraq. Thus, the current focus of Iraqi politicians is on the role and authority of federal and regional government in oil policy, foreign participation in oil and gas production and the mechanisms for revenue sharing.¹⁴²

The question implied by this research is whether the CPA's economic reform delivered broad economic growth in Iraq. The examined literature is by no means conclusive on this matter. The result of CPA's implementation of the Washington consensus in Iraq is mixed. Indeed even under the most optimal conditions macroeconomic policy is no silver bullet. The effort was constrained in particular by an

¹³⁹ Blanchard, Christopher, "Oil and gas Legislation, Revenue Sharing, and U.S. Policy" *Congressional Research Service*, November (2009): 1, <http://www.fas.org/sgp/crs/mideast/RL34064.pdf>.

¹⁴⁰ *Ibid.*, 16.

¹⁴¹ *Ibid.*, 20.

¹⁴² *Ibid.*, 5.

Iraqi economy that lacked skilled professionals in the banking industry and more generally hobbled by the legacy of government control over the economy. The Middle East is a region of notorious resistance to economic and political reform. The conclusion that drawn from this analysis is that the CPA's broad attempt to distance the banking sector from government influence was successful, though incomplete. The targeted banking area was but one sector of Iraq's economy and reforms in that area should not be viewed as necessarily capable of delivering broad and sustained economic growth. The policy implications of this research suggests that while implementing controversial and dogmatic programs such as the neoliberal economic reform can produce lasting changes, the benefits are limited to the specific policy targets. Even so, the partial success of such programs foster credible hope in terms of transitioning statist economies out of the hands of the government onto professional managers who may be motivated by empirical incentives.

This thesis determined that the CPA's rapid implementation of central bank independence and currency unification transitioned Iraq's economy from a symbol of Saddam's corrupt regime into a fledgling modern system. The selection of shock therapy introduced a large amount of uncertainty about the sustainability of neoliberal economic reforms. In spite of the CPA's macroeconomic reforms, Iraq's economy remains undiversified and reliant on revenue from oil export. Although the monetary reforms of a single stable currency and an independent central bank were important to liberating Iraq, macroeconomic policy is but one instrument that addresses specific aspects of a broader economic situation. This is especially the case in transitioning statist and resource exporting countries such as Iraq.

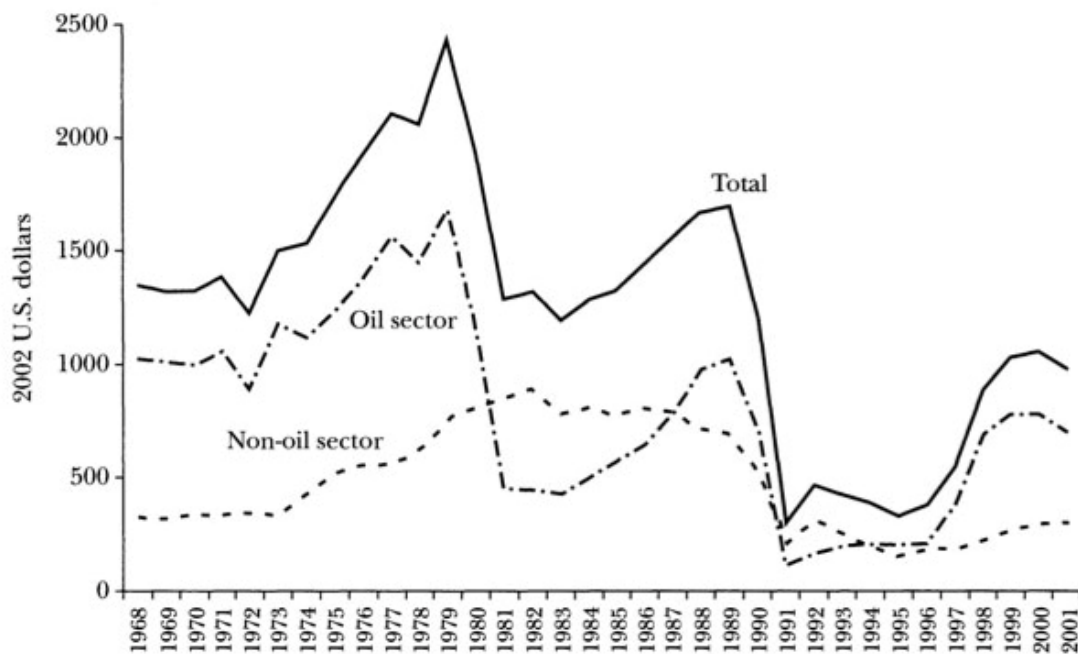


Figure 7. Per Capita GDP in Iraq (1968–2001)¹⁴³

Iraq has politically transitioned, but the economy remains hampered by the persistent violence and stagnation. Research suggests that the level of violence is closely correlated with the economic performance. Although there is a chicken and egg relationship between violence and economic opportunity recent polls indicate Iraqis believe that increased economic opportunity would quell the violence.¹⁴⁴ Whether Iraq diversifies and transforms into a modern market-oriented economy is uncertain. What is certain is that the CPA's neoliberal reforms have produced lasting transformations, including the necessary groundwork for the further development of independent macroeconomic institutions.

¹⁴³ Foote et al., "Economic Policy and Prospects in Iraq," *Journal of Economic Perspectives* 18, no. 3 (2004): 58, <http://www.jstor.org/stable/pdfplus/3216806.pdf>.

¹⁴⁴ Ibid., 50.

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